

Designing a Legal Regime to Capture Capital Gains Tax on Indirect Transfers of Mineral and Petroleum Rights: A Practical Guide

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PREFACE

When a local asset (or a right relating to such asset) is sold, a country will generally have jurisdiction to levy a capital gains tax on the sale, both under domestic law and international treaty. This is called taxation of a “direct” transfer of a local asset. This is, however, more complicated when a company located offshore ultimately owns the local asset. It is even more complicated when the local asset is held by a chain of corporations with some of them located in tax havens.¹

If it is not the asset that is sold but the shares of the domestic subsidiary, the shares of the foreign company with a branch in the country or the shares of the holding company, it is an Indirect Transfer of the underlying asset. In this situation, the right of the source country (where the asset is situated) to tax the capital gains arising from this transfer is problematic. In many such cases, “... the accrued gain attributable to the underlying assets which has accrued in the source country would escape taxation by the source country on the transfer,”² unless the domestic law has special provisions to capture the gains made through such an Indirect Transfer.

Building on the momentum created by the Platform's paper on taxing Indirect Transfers of source country assets, this paper aims at providing practical guidance to address the taxation of Indirect Transfers of assets of extractive industries that are located in developing countries. It focuses on issues that developing country governments may wish to consider if they adopt a policy to tax such transfers. In doing so, it examines the language of the legislative and regulatory provisions employed by countries that have adopted such a policy to tax and comments on the pros and cons of these provisions.

1. INTRODUCTION

1.1 Types of Indirect Transfers - the Headlines

A brief examination of several cases will serve to illustrate the nature of the issues raised by Indirect Transfers.

¹ When a foreign company invests in a country, the investment can be structured either as a locally organized subsidiary or as a branch of a foreign corporation. A branch of a corporation is not a separate legal entity of the parent corporation. A locally organized subsidiary is a separate legal entity from the parent, although owned by the parent corporation. Multinationals over time have created sophisticated structures utilizing holding companies to own local subsidiaries that are organized in a variety of jurisdictions in order to take advantage of a network of international tax treaties and low tax rates.

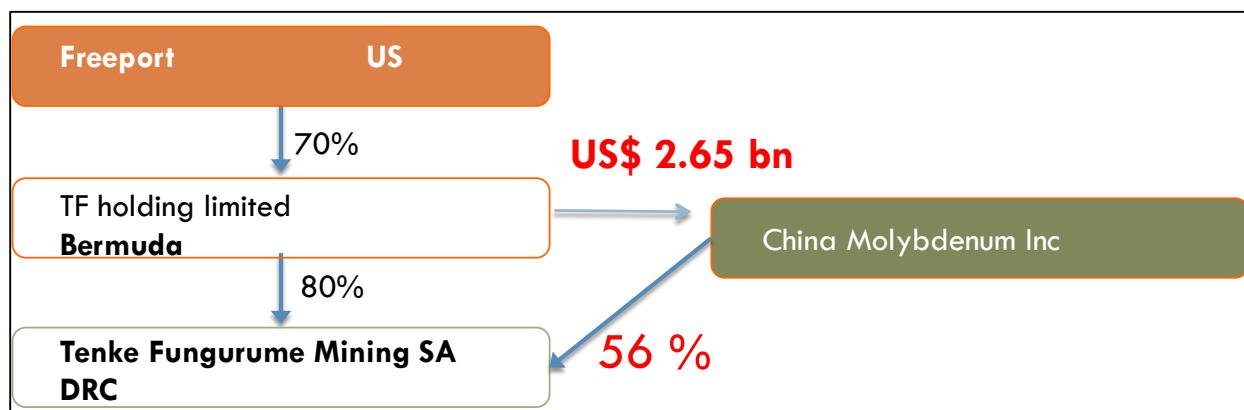
² UN Handbook, (2015), p. 34, available at: <http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf> (last visited 18 October, 2017).

1.2 Freeport – CMOC transaction

In early May 2016, the miner Freeport McMoRan sold its 56% controlling stake in the Tenke Fungurume copper mine - one of the biggest mining projects in the Democratic Republic of Congo (DRC) - to China Molybdenum Inc. (CMOC) for \$2.65 billion.³ The DRC received nothing from this deal. Indeed, the DRC did not even know it was happening, despite owning a 20% equity stake in the project. This is because Freeport did not directly sell the Tenke Fungurume copper mine.

Freeport sold its 70 % interest in TF Holdings Limited, a Bermuda holding company that owned an 80 % interest in Tenke Fungurume Mining SA, the company owning the mine. As a result, Freeport only owned its 56 % interest in Tenke Fungurume Mining SA and in the copper mine “indirectly”. It is the indirect stake that CMOC acquired. Thus, the acquisition of DRC mining rights was done in a jurisdiction outside of the DRC.⁴

Figure 1: The Freeport transaction⁵



This episode follows a long series of similar cases, two of which are briefly described below.⁶

³ China Molybdenum Co., Ltd, Media Release "CMOC to Acquire Freeport's Indirect 56% Interest in Tenke Fungurume for US\$2.65bn" (9 May, 2016), available at: [http://www.chinamoly.com/05news/DOC/CMOC_Press_Release_\(English\)_vF.pdf](http://www.chinamoly.com/05news/DOC/CMOC_Press_Release_(English)_vF.pdf) (last visited 18 October, 2017).

⁴ Oxfam's Politics of Poverty blog entry by 'Guest Blogger', "DRC's largest mine was just sold. And DRC got nothing" (3 August, 2016), available at: <http://politicsofpoverty.oxfamamerica.org/2016/08/drcs-largest-mine-was-just-sold-and-drc-got-nothing/> (last visited 18 October, 2017).

⁵ The diagram is authors' own.

⁶ This paper does not discuss the well publicized recent case involving Heritage and Tullow Oil vs. Uganda, because that involved Uganda's effort to tax a direct transfer of Uganda oil exploration licenses, rather than an Indirect Transfer. (In 2010, Heritage Oil sold its exploration licenses in the Albertine Rift to Tullow Oil for US \$1.45 billion, and then it ceased to operate within Uganda. When the Government of Uganda claimed a capital gains tax on the deal, Heritage argued

1.3 Riversdale – Rio Tinto Transaction

Riversdale, an Australian public company, owned the rights to a massive coal project in Mozambique through its Mauritius holding company and its Mozambican registered subsidiary, Riversdale Mozambique Limitada. Through purchasing Riversdale on the Australian Stock Exchange, Rio Tinto acquired the rights to the chain of companies, including Riversdale Mozambique Limitada, which directly owned the coal project. The Mozambique government was not notified of the transaction and did not receive anything despite the significant increase in value in the mineral rights since the exploitation rights were initially granted.⁷ Six years later the Mozambican government is still trying to impose a capital gains tax on Rio Tinto.⁸ Of course, this is not only an African issue.

1.4 Exxon – Disputada de las Condes

In 2002, Chile did not react well to discovering that it would not collect one penny from Exxon Mobil's sale of Disputada de las Condes to South Africa's AngloAmerican Oil for \$1.3 billion through an offshore transaction in the Cayman Islands. Chile then decided to adopt retroactive regulations to capture such Indirect Transfers, in order to collect \$300 million in capital gains tax.⁹

2. TWO MODELS TO TAX INDIRECT TRANSFERS

In the Platform Paper, the authors suggest two models for taxing such transfers:

- **Model 1:** Taxing the local resident asset-owning entity under a deemed disposal model.
- **Model 2:** Taxing the non-resident seller.

In Model 1, once the source country learns of the transfer of a controlling interest in a company within its jurisdiction by an offshore investor, the source country would treat the transfer as though the source country company had sold its assets to a new deemed

that the sale took place outside of Uganda and was not subject to tax by Uganda. A considerable amount of litigation followed between all of the parties.)

⁷ Creamer Media's Mining Weekly article by Keith Campbell, "Mozambique expects capital gains tax on mining transactions", (4 April, 2014), available at: <http://www.miningweekly.com/article/mozambique-expects-capital-gains-tax-on-mining-transactions-2014-04-04> (last visited 18 October, 2017).

⁸ The value of mineral rights can change rapidly. In this case, Rio Tinto later sold the Benga Mine at a loss to India's International Coal Ventures Limited (ICVL) for a mere \$50-million in 2014.

⁹ The Wall Street Journal article, "Chile, Exxon, Disagree on Mine Sale", (9 September, 2002), available at: <https://www.wsj.com/articles/SB1031616498175349275> (last visited 18 October, 2017).

source country company. Thus, it would tax the Indirect Transfer as though a direct sale of assets had occurred.

In Model 2, the source country would tax the offshore investor on a transfer of an interest in a source country company.

A number of advantages and disadvantages are set out in the Platform Paper on the two models. Model 2 is the predominant model that is followed by countries today. Since it is the predominant model and this paper is designed to provide practical advice to the tax authorities seeking to tax Indirect Transfers, it is the only model discussed in the balance of this paper. Further, we believe that it is the better model to follow. The advantages and disadvantages of both models are briefly discussed in the Annex.

3. HOW TO ESTABLISH LEGAL AUTHORITY IN SOURCE COUNTRY LAW TO TAX INDIRECT TRANSFERS

3.1 Reach of the Law

What provisions should be enacted in the source country laws giving it the right to tax Indirect Transfers? In response to the issue outlined in the Introduction, a number of host countries have implemented domestic legislation to seek to capture some of the benefit of transfers of assets carried out offshore. Other countries are still looking at how to capture this benefit, or have identified defects in their current system, and this paper is particularly intended for them.

Historically, the reach of a country's law extended only to persons or property within the jurisdiction of the courts of the country.¹⁰ This notion underlies the historical focus of the tax law on taxing Indirect Transfers only of "immovable property," which is the type of property that clearly lies within a given jurisdiction (since literally it cannot be moved).

Practically, there are two strong arguments in favour of taxing Indirect Transfers: (1) It will protect the integrity of the tax law that provides for the taxation of direct transfers of these interests (i.e., where the tax law requires payment of a tax where there is a direct transfer of a mineral interest, an interest holder should not be in a position to avoid payment of the tax simply by carrying out the transfer off-shore, and/or through an

¹⁰ The discussion in this and the following paragraph draws on the analysis contained in: L. Burns, H. Le Leuch and E.M. Sunley, "Taxing gains on transfer of interest", (2017), Chapter 7, Section 4.1; found in P. Daniel, M. Keen, A. Swistak and V. Thuronyi (eds.), "International Taxation and the Extractive Industries", Routledge, London & New York.

intermediary company). (2) It complies with existing norms (developed by the OECD and the UN) that permit the indirect taxation of interests in immovable property.¹¹

The argument against taxing Indirect Transfers is that enforcing such taxation is difficult and often leads to contentious disputes with in-bound investors in the country in question, in particular when the law does not clearly provide for the taxation of Indirect Transfers.¹²

While this paper is focused on the tax law of countries, we wish to stress the importance of including appropriate tax provisions in concession or other contractual agreements dealing with mineral or petroleum interests in regimes when these agreements are used to govern extractive projects.¹³ These agreements can fruitfully include provisions dealing with the taxation of indirect dispositions of interests in extractive project assets particularly if the law and regulations are not written well enough to fully address Indirect Transfers. See Section 7 of this Guide for a further discussion of concession agreements.

Going back now to the establishment of the jurisdiction (i.e. legal authority) to tax, assume a country intends to tax both direct and Indirect Transfers of immovable property. The law used to tax such transfers generally will read along the following lines:

Gains will be subject to tax when derived from the disposal of a substantial interest in an entity the value of which is derived, wholly or principally, directly or indirectly, from immovable property in [the source country].

To operationalize this general principle, laws or regulations should clearly and non-ambiguously define “when” to assess whether the tax applies and “what” to tax. Defining the “when” and the “what” will involve defining the key phrases of the sample provision above: “substantial interest”, “wholly or principally” and “immovable property”. Each is discussed in the sections that follow.

¹¹ The Platform Paper goes into an extended discussion of the economics underlying the source country’s right to tax Indirect Transfers, including a discussion of “location specific rents”. This paper is a practical paper on how to tax Indirect Transfers and does not go into the underlying economics justifying such taxation.

¹² Some will also argue that such taxes will discourage the investment of genuine exploration companies whose reward only arises from the Indirect Transfer of the license to major producers. To accommodate this argument, the capital gains tax should be set at a sensible level – such level should be defined on a country-by-country basis depending on the quality of the geological deposit. On the other hand, some transfers occur before the transferor has spent a cent other than the cost of acquiring the exploration right. In a reasonably perfect market, the price paid by a mining company to a host country for an exploration right should be close to the value of the right. Transfers of bare exploration rights resulting in gains simply shows that the host country failed to price the exploration right properly, and the transfer tax can be viewed as a partial rectification of that failure. Unfortunately awards of concessions also involve opportunities for corruption.

¹³ Resource rich countries with strong and comprehensive laws and regulations should not need to give up taxing rights in their concession agreements in most cases.

3.2 Different Types of Test to Determine Whether a Capital Gains Tax Applies

What sort of test should the source country law use to determine whether a taxable Indirect Transfer has taken place? There are two main possibilities.

(a) A test using relatively objective, specific criteria

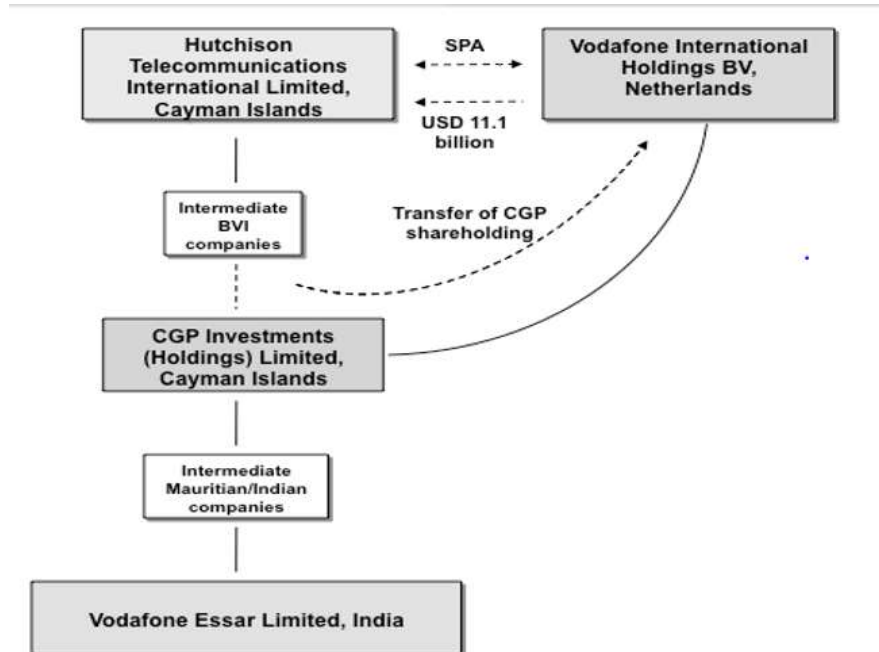
One method is to set out in the legislation some objective parameters which make clear in advance which types of transfers will be subject to capital gains tax. The tax is then imposed on any transfer that falls within those parameters (which can be subject to listed exceptions).

India implemented this method by a 2012 amendment to its Income Tax Act (Finance Act 2012). This was done in response to India's unsuccessful attempt to apply a capital gains tax on the sale by a subsidiary of Hutchinson Telecommunications of a Cayman Islands subsidiary owning an Indian company, Hutchison Essar, to Vodafone, a Dutch company.¹⁴ Hutchison Essar held and operated telecommunications licenses in India. In that case the buyer, seller and company being sold were all non-Indian companies, and the Indian Supreme Court ruled that the transfer was not subject to capital gains tax under the Indian law at the time.¹⁵

¹⁴ The Vodafone case leading to the change in the Indian law is distinguishable from the situation primarily addressed in this paper in that it did not deal with mineral interests that fall within the domain of immovable property; rather, a telecommunications business ("mobile" by nature) in India was being indirectly sold. As explained above, broad international consensus holds that the Indirect Transfer of an interest in immovable assets located in a source country is subject to tax by the source country. However, the same consensus does not exist regarding the Indirect Transfer of other types of assets. For instance, Article 13 of the Model Tax Conventions of both the U.N. and the OECD provide for taxation by the source country of the indirect disposition of an interest in immovable assets whereas only the U.N. Model Convention currently gives a source country the option to tax the indirect disposition of shares of a company holding other forms of property.

¹⁵ This specific section of the Indian Law, section 9 of the Income Tax Act, and its various permutations over time can be found here: <https://www.taxmann.com/budget-2015-16/file/samd428/earlier-section.aspx> (last visited 18 October, 2017).

Figure 2: Vodafone – Hutchison Transaction¹⁶



Hutchison and Vodafone enter into a share purchase agreement (SPA) pursuant to which CGP Investments was sold to Vodafone.

Following this ruling, the India government decided to amend the Income Tax Act:

Box 1: India: Relatively Objective, Specific Criteria

Section 9(1)(i): India shall tax "all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India or through the transfer of a capital asset situated in India".

Explanation 5 to Section 9(1)(i) of the Act: "For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and **shall always be deemed to have been situated in India, if the share or interest derives, directly or**

¹⁶ Diagram from N.M. Desai and M. Kumar, "The Vodafone Saga – An Analysis of the Indian Supreme Court's Decision", 66 Bull. Intl. Tax. 7 (2012), Journals IBFD.

indirectly, its value substantially from the assets located in India (emphasis supplied).“
(Income Tax Act 1961, section 9, as amended in 2012)¹⁷

(b) A test using relatively subjective, general criteria

Alternatively, a country can apply more subjective or general criteria in determining the types of Indirect Transfers that will be subject to tax. Typically, such a test might be expected to provide less clarity for taxpayers in advance of a transfer, but it may also provide for more flexibility in its application. More emphasis may be placed on an assessment after a transaction, for instance, of whether or not the transaction was undertaken for the purpose of tax avoidance.

China has taken this type of approach, evaluating the purpose of a transaction after the event. If the transaction is determined not to have a “bona fide commercial purpose”, then it will be subject to taxation.¹⁸

Box 2: China: Purpose Test

“When a non-resident enterprise (NRE) engages in an indirect transfer of assets, including shares of Chinese resident enterprises, through an arrangement that **does not have a bona fide commercial purpose** in order to avoid paying enterprise income tax (EIT), the transaction should be re-characterized as a direct transfer of the Chinese assets in accordance with article 47 of the EIT law (emphasis supplied).” **(Article 1, Bulletin [2015] No.7)**

“Assets” are assets attributed to an establishment in China, immovable property in China and shares in Chinese resident enterprises.¹⁹

(c) Hybrid approach: a specific test backed up by a GAAR

Peru takes a combined approach, where it sets out objective parameters by which to determine whether a capital gains tax should apply, but also includes in its tax law a form of SAAR to ensure that transfers carried out offshore for a purpose of avoiding a capital gains tax are captured.

¹⁷ The Indian Income Tax Act provision quoted is available at: <http://www.incometaxindia.gov.in/Pages/acts/income-tax-act.aspx> (last visited 18 October, 2017).

¹⁸ China's State Administration of Taxation, Announcement Number 7, 2015 (replaces Circular 698).

¹⁹ The law quoted is taken from Deloitte's “China Tax Alert” of 6 February, 2015, available at: <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtfl-tax-alert-china-060215.pdf> (last visited 18 October, 2017).

Box 3: Peru's Indirect Transfer Test

Under **Law 29757, Article 2**, capital gains derived from an Indirect Transfer of the shares of a Peruvian legal entity currently fall within the scope of the Peruvian tax net if the following conditions are satisfied:

"When the shares of a nonresident entity that owns, directly or indirectly, shares of a Peruvian company are transferred and either:

a. The market value of the shares of the Peruvian company owned directly or indirectly by the nonresident entity is equal to 50% or more of the market value of all of the shares representing the equity capital of the nonresident entity ("50% market value rule") for the 12-month period before the transfer, and there has been a transfer (or transfers) of shares representing 10% or more of the equity capital of the nonresident entity within the relevant 12-month period (in the event of an audit, the tax authorities have the burden of demonstrating that these conditions are satisfied); or

b. The nonresident entity is resident in a tax haven or low tax jurisdiction, unless it can be demonstrated that the conditions in the previous bullet are not satisfied (in the event of an audit, the taxpayer has the burden of demonstrating that these conditions are not satisfied)."²⁰

Summary of alternatives

- **India:** Employs objective criteria established in advance to define transactions that are subject to tax.
- **China:** Employs subjective criteria after the transaction in the nature of a SAAR.
- **Peru:** A combination of the two approaches.

Pros and cons of the alternatives, including the use of a SAAR or a GAAR

- **Objective criteria:** This system provides greater certainty to taxpayers and the government about the treatment of future transactions and may be perceived as fairer.
- **SAAR:** A SAAR provides governments with greater flexibility in addressing future transactions, the shape of which cannot be known in advance. The provision used by China is specifically directed at Indirect Transfers and so is a version of a SAAR.
- **GAAR:** A country could adopt a GAAR that that would cover any transaction not having a bona fide commercial purpose, including Indirect Transfers. Because its provisions would not be limited to any specific type of transaction, the enactment of a GAAR may create considerable uncertainty in the application of a country's tax law. Nevertheless, a number of countries have adopted GAARs.

²⁰ The quoted language is taken from a note prepared by Deloitte entitled "Peru: Non-residents must obtain certification of tax basis for indirect transfers of shares." The note explains the law, but does not reproduce the law itself. The note is available at: http://newsletters.usdbriefs.com/2015/Tax/WTAT/150508_4.pdf (last visited 18 October, 2017).

3.3 Defining the Types of Asset to Which the Capital Gains Tax Will be Applied

In considering establishing the legal authority to tax Indirect Transfers of Mineral and Petroleum Rights, it will be essential to determine whether they are the types of underlying assets that should trigger a tax charge on an Indirect Transfer. The core of the test about the types of underlying assets that trigger a charge is often captured in a definition of “immovable property”.

Immovable property should be defined clearly and broadly so as to capture mining and oil rights and licenses and any development activities relating thereto. If this is done, the sale of shares of companies holding rights or licenses in immovable property as so defined will be brought into the ambit of the tax. The definition also should be reflected in international treaties entered into by a source country (see also Section 6 of this Guide). Canada provides a good example of a strong definition:

Box 4: Canada: Definition of Property for Capital Gains Tax Purposes

“For dispositions after March 4, 2010, the taxable Canadian property (TCP) referred to above generally includes the following:

- real or immovable property situated in Canada; (...)
- shares of corporations that are not listed on a designated stock exchange, an interest in a partnership, or an interest in a trust, if at any time in the previous 60-month period, more than 50% of the fair market value of the shares or interest was derived (otherwise than through a corporation, partnership or trust the shares or interests in which were not themselves taxable Canadian property at the particular time) from one or any combination of:
 - real or immovable property situated in Canada;
 - resource property situated in Canada;
 - timber resource property situated in Canada; and
 - options or interests in any of the above.
- shares of corporations listed on a designated stock exchange, a share of a mutual fund corporation or unit of a mutual fund trust, if at any time in the previous 60-month period:
 - (1) 25% or more of the issued shares of any class, or 25% or more of the issued units, belonged to either the taxpayer or the taxpayer and persons with whom the taxpayer did not deal with at arm's length; and (2) more than 50% of the fair market value of the shares or unit was derived from one or any combination of:
 - real or immovable property situated in Canada;
 - resource property situated in Canada;
 - timber resource property situated in Canada; and

- options or interests in any of the above; or an option or interest in any property listed above." **(Income tax information circular IC72-17R6, Art. 2)**²¹

Under Canadian law, the disposition of mineral rights is considered to be a disposition of "Canadian resource property".

As seen in the discussion of international treaties below in Box 14, the Model Conventions of the UN and the OECD leave the definition of "immovable property" to each country to define. Accordingly, countries may wish to consider a definition such as that included in the Canadian tax law for "resource property" to ensure that mineral rights are included in the term "immovable property".

4. KEY ASPECTS OF A LEGAL FRAMEWORK TO TAX INDIRECT TRANSFERS

Once a country decides to tax the capital gains arising from Indirect Transfers, there are a number of issues that it must consider with respect to the design of legal reforms to implement that decision. The way in which the tax will be imposed will come down to the country's tax policy as well as its ability to administer the tax. This Section discusses key aspects of that design.

4.1 How to Determine the Value of the Transfer?

The tax administration must be in a position to determine the value of the gain made by the seller. This can be difficult if the transfer occurs offshore in a non-resident entity, and the source country must rely solely on the information provided by the seller as to the value of the gain.

Typically, the gain on a transaction will simply be calculated as the difference between (a) the investor's basis in the interest being assigned (in general, the original acquisition cost together with any additional capital contributions) and (b) the consideration being received for the transfer of the interest. However, in some cases, the tax authorities may have difficulty in obtaining the information on the investor's basis or in verifying it. In these cases, for publicly listed companies and for privately held companies for which the information is available, the authorities may wish to substitute the paid-in capital (i.e.: initial capital investment in company together with any subsequent capital contributions) of the entity in question (or the percentage of paid-in capital attributable to the interest involved) for the basis in the interest. In such a case, the law or regulations should permit the investor to offer proof that another value is more appropriate.

²¹ Canada Revenue Agency, Income Tax Information Circular IC72-17R6, "Procedures concerning the disposition of taxable Canadian property by non-residents of Canada – section 116", (29 September, 2011), available at: <http://www.cra-arc.gc.ca/E/pub/tp/ic72-17r6/ic72-17r6-11e.pdf> (last visited 18 October, 2017).

In any event, the seller and the buyer should be required to provide verifiable information regarding the value of the transfer (a copy of the sales agreement and any related agreements with appropriate certification by senior officers of the companies), and the country should have the right to independently verify the information provided. Sharing tax information between countries may also assist in that regard (several measures deployed by the OECD may facilitate this exchange of information – including with developing countries).²²

4.2 What Percentage or Value of Gain has to be Derived from Source-Country Assets in Order for the Tax to be Triggered?

Most source countries tax the gain from shares of a non-resident company only if the value of its shares is derived principally (more than 50%) from the assets located in the source country. In South Africa, however, the bar is set higher: only if 80% or more of a company's assets consist of mineral rights in South Africa will the disposal of that company's shares be treated as a disposal of the mineral right itself. If a non-resident makes such a gain, it is taxable as a South African sourced gain.

Box 5: South Africa: Threshold of Application

"(...) [A]n interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested interest of a person in any assets of any trust, if:

- a. 80 per cent or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and

²² Under Action 13 of the BEPS project on country-by-country reporting, each Multinational Enterprise (MNE) is required to prepare three files: (i) a "master" file containing high level information about the MNE's global business, (ii) a "local" file setting out transactional transfer pricing specific to each country, and (iii) a "country by country" report containing a jurisdictional breakdown of profit before tax and tax paid. The first two files are to be delivered to affected jurisdictions; the last file is to be given only to the MNE's home country. These files should contain information helpful to source countries in imposing a capital gains tax. The last file, probably the most important of the three, is not to be given to the source country. This diminishes the value of this action item insofar as most developing countries are concerned. Wei Cui notes that the country-by-country reporting requirements as now written may fall short of expectations regarding information on Indirect Transfers. His main concerns relate to the high threshold of a MNE's group's revenue before reporting is required (an amount equal to or exceeding €750 million) and the level of aggregation of the information in the files. The Global Forum for the exchange of tax information also is designed to provide tax authorities with certain tax information. The Action 13 – 2015 Final Report, "Transfer Pricing Documentation and Country-by-Country Reporting", (5 October, 2015), is available at: <http://dx.doi.org/10.1787/9789264241480-en> (last visited 18 October, 2017). See also OECD (2017), *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*, OECD, Paris, is available at: <http://www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf>; OECD (2017), *Country-by-Reporting: Handbook on Effective Implementation*, OECD, Paris is available at: <http://www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-implementation.pdf> (both, last visited 22 October, 2017).

b. in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20 per cent of the equity shares in that company or ownership or right to ownership of that other entity". **(Paragraph 2(2) of the Eighth Schedule – Income Tax Act as amended in 2002)**²³

A minimum value of assets (for example \$10 million) may be used instead of, or as well as, a minimum percentage. In India too, in response to investor concerns, further explanations were added to the Income Tax Act in 2015 (Finance Act 2015) to provide for a minimum value condition.

Box 6: India: Threshold of Application

Explanation 6 to section 9(1)(i) clarifies that to “derive its value substantially from assets located in India” means that (i) the value of the Indian assets must exceed INR 10 crore; and (ii) represent at least 50% of the value of assets owned by the foreign company whose shares are being directly or indirectly transferred, and that the value of an asset shall be the fair market value as on the specified date, of such asset without reduction of liabilities, if any, in respect of the asset, determined in such manner as may be prescribed; [“specified date means the—(i) date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest; or (ii) date of transfer, if the book value of the assets of the company or, as the case may be, the entity on the date of transfer exceeds the book value of the assets as on the date referred to in sub-clause (i), by fifteen per cent”.] Explanation 7 provides a carve out for transfers of shares of a foreign company deriving substantial value from Indian assets by investors who hold less than 5% of the interest in such foreign company. **(Income Tax Act 1961, section 9 – as amended in 2012)**²⁴

Other countries might decide that Indirect Transfers should be taxed only when a “change in control” occurs. This term can be construed both broadly and narrowly by those interpreting it. Some might argue that a wide range of transactions result in a change in control; others might contend that even substantial Indirect Transfers did not result in a change in control. Consequently, if a change of control provision is adopted, it should be carefully drafted to ensure that all significant transactions are clearly covered by the legislation and that it does not unintentionally subject small transfers of interests to tax. A comprehensive provision comes from the Guinean mining code²⁵:

²³ Paragraph 2(2) of the Eighth Schedule of the South African Income Tax Act 1962 is available here: https://www.acts.co.za/income-tax-act-1962/sch_8_part_i_general (last visited 18 October, 2017).

²⁴ See footnote 17.

²⁵ When defining change in control, it should be clear that not all change in control transactions are taxable events. For instance, there can be a case whereby a corporate control dispute at the level of the ultimate holding company arises. Shareholders may switch sides and elect a completely new board – beholden to a new set of shareholders - without any

Box 7: Guinea: Definitions of Change of Control

“When there is an indirect change of control of a legal entity holding a Mining Permit or an Authorization, all assignments of ownership interest over the twelve months prior to this acquisition of indirect control, which have conferred this indirect control to an individual or legal entity, are taxed according to the capital gains regime.

Indirect control is understood to be a series, without any particular limitations, of similar acquisitions of ownership interest (several companies owning interests in the same company) and/or vertical acquisitions of ownership interests (one company successively controlling one or more companies), enabling the individual or legal entity to exercise influence or control over the legal entity holding the Mining Permit or Authorization. Influence is established when the individual or legal entity effectively participates in decisions relating to the management and financial policies of the issuing company. Control is established: - when the individual or legal entity directly or indirectly holds part of the capital conferring the majority of the voting rights in the issuing company's shareholders meetings; - or, when it holds the majority of the voting rights in this company pursuant to an agreement signed with other partners or shareholders. - or when it actually determines the outcome of decisions, with the voting rights it exercises, in the shareholders meetings of that company.” **(Mining Code as Amended in 2011, Article 91 –III)**²⁶

Summary of alternatives

- **Canada:** In Canada, the tax applies when more than 50% of any gain in the interest being assigned is attributable to immovable property (the extractive assets) located in the source country.
- **India:** In India, the law appears to adopt a measure using the gross value of the assets located in India since the rules for determining the fair market value of assets located in India do not include the consideration for liabilities related to the assets. If the law is construed in this fashion, it may lead to the taxation of transactions where the market value of a company in India is substantially less than 50% of the total value of the entity that is the subject of the Indirect Transfer.
- **South Africa:** Similar to the Canadian test, but the threshold is 80% or more of the gain (“market value of those equity shares [being sold]”). This test is combined

share transfer or other direct economic gain accruing to any shareholder. Such a transaction results in a change in control but should not be taxable. The Guinea law seems to avoid this problem by dealing only with control changes that arise from ownership interest transfers.

²⁶ The 2011 Amended Mining Code of the Republic of Guinea is available here in French and in English translation: [http://www.eisourcebook.org/cms/June%202013/Guinea%20Mining%20Code%20\(in%20French%20&%20English\)%20as%20amended%202011.pdf](http://www.eisourcebook.org/cms/June%202013/Guinea%20Mining%20Code%20(in%20French%20&%20English)%20as%20amended%202011.pdf) (last visited 18 October, 2017). We used the English translation. Governments should be aware that the wording of this last criterion for the establishment of control can be subject to interpretation. For instance, in a shareholders meeting in which a matter was decided by a vote of 52%-48%, anyone who held over 2.1% of the shares could be said to have determined the outcome – or, in the alternative, only the last person to vote “determined” the outcome. Unless coupled with an Indirect Transfer of a more substantial interest, it is arguable that this type of change in control should be subject to tax.

- with a test regarding the size of the interest of the transferor being assigned.
- Guinea – The test is whether there has been a change in control.

Pros and cons of the alternatives: A higher minimum percentage, particularly when combined with a minimum value of the interest being sold, makes compliance easier for government authorities. It also simplifies the issue of apportioning the gain to tax (raised below). However, a lower minimum provides the source country with a greater tax base.

4.3 Whether to Proportion the Gain Subject to Tax?

Another issue to consider is once the minimum asset or value requirement is met (if one applies), should the entire amount of the capital gain be taxed or only an amount which is proportionate to the source country assets?

In many cases the sale will consist of all the shares of, or a controlling interest in, an offshore company that is a single purpose entity established for a single project in the source country, and the vast majority of its assets will be property located in the source country. Accordingly, most countries tax the entire gain once the threshold of ownership for taxing a transfer on a sale is met.

However, India has taken the approach of taxing the proportion of the value that is derived from the Indian assets (calculated according to a formula set out in "Rules" put out by the government in 2016).²⁷ However, as noted above, the rules may lead to taxing gains determined without regard to liabilities to which assets are subject. This may lead to the overweight of the relative value of the Indian assets as compared to the non-Indian assets, and consequently arguably to the imposition of an unfair tax on the gross basis of assets located in India. Similar to India, the Guinean mining code only taxes the proportion of the value that is derived from the Guinean assets when the entity realizing the gain has assets located in Guinea and one or more other jurisdictions.

Box 8: Guinea: Taxing Proportionately

"This capital gains value recorded for an individual or legal entity having assigned its shares or other ownership interest to a legal entity holding a Mining Permit or Authorization is deemed to be of Guinean origin in so far as the assets of the legal entity whose shares or ownership interests have been assigned are located in Guinea. When the assets of the legal entity from whom shares or other ownership interest have been assigned are located in several jurisdictions, the capital gain is calculated solely on the value of the

²⁷ Indian Central Board of Direct Taxes, Notification S.O. 2226(E), 28 June, 2016, at Rule 11UC, summarized at: https://www.pwc.in/assets/pdfs/news-alert-tax/2016/pwc_news_alert_1_july_2016_computation_of_income_attributable_to_indirect_transfer_of_assets_and_reporting_thereon.pdf (last visited 18 October, 2017).

assets belonging to the Guinean subsidiary.”²⁸ (**Mining Code as amended in 2013, Article 91 –II**)

Summary of alternatives

- **India and Guinea:** Tax only the proportion of gain attributable to assets located in country in the case where the entity being sold has assets in more than one jurisdiction. The basis of the calculation is gross assets in India and net assets in Guinea.
- **Majority of other countries:** Tax all of the gain irrespective of where the assets are located provided a minimum threshold to trigger the tax is met.

Pros and cons of the alternatives: The position of Guinea makes for a fairer application of the tax. The negative to this approach is that it imposes administrative difficulties in determining how to split the gain.

4.4 Whether to Grant Exemptions and Under Which Circumstances?

Some countries include exemptions to the application of the tax legislation, to carve out certain situations where it may be less appropriate to apply the capital gains tax. Again, this will depend on public policy.

One exemption that is sometimes applied is for shares that are publicly traded on a stock exchange. The reason behind this exemption is said to be that it is considered less likely that a publicly traded company has been created for the purpose of tax avoidance.²⁹

China provides such an exception for the normal trading of listed shares. It applies where there is an Indirect Transfer of Chinese assets by selling or buying interests in an offshore listed enterprise on a public market. This may reflect China's approach to the application of capital gains tax on Indirect Transfers which is based on whether the arrangement in question has a legitimate business purpose.

Thus, Article 5 of Bulletin 7 of the Chinese law creates the “safe harbor”, specifying when the rules regarding Indirect Transfers will not apply: “Where a non-resident enterprise derives income from an indirect transfer of Chinese Taxable Assets by acquiring and selling Shares in an offshore listed enterprise on a public market.”³⁰

However, having such an exemption may prevent the source country from taxing a sale

²⁸ See footnote 28.

²⁹ W. Cui, “Taxing Indirect Transfers: Improving an instrument for stemming tax and legal base erosion”, (2014) in Virginia Tax Review, Vol 33:653, 677 (hereinafter, Cui).

³⁰ The law quoted is taken from Deloitte’s “China Tax Alert” of 6 February, 2015, available at: <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtfl-tax-alert-china-060215.pdf> (last visited 18 October, 2017).

of the shares of a public company traded on a stock exchange in a transaction where the public company is acquired by an unrelated entity, or when a substantial shareholder disposes of its interest in a public sale of stock.³¹

Accordingly, instead of such an exemption, a country could use a minimum stock ownership requirement. Such a rule would mean that a transaction would be subject to capital gains tax only if a sale involves a transfer directly or indirectly of more than a certain percentage of ownership in an entity. The country would have to determine in its law what percentage is appropriate to constitute a sufficiently substantial interest. For example, in South Africa the percentage is set at 20% of the stock of the company owning directly or indirectly the mineral or petroleum rights (see Box 5). Stock ownership could be determined by value or voting power (see the Canadian example above, Box 4).

The Indirect Transfer law should be written so that minimum stock ownership or substantial disposal thresholds cannot easily be avoided through fragmenting ownership or transfers. That could be achieved, for example, by a rule that aggregates ownership interests or disposals made within a particular period of time or by connected parties (again see the Canadian example language applicable to listed shares at Box 4).

China also provides a tax treaty exemption exception – in the case where if the transferor in an Indirect Transfer had directly disposed of a Chinese company, the income from the transfer would be exempt under a tax treaty. The risks associated with tax treaties and the ability to impose capital gains tax on the Indirect Transfer of assets are explained in the section 6 below.

Summary of alternatives

- **South Africa and other countries:** Indirect tax is not triggered unless a minimum threshold of the ownership of the entity is being assigned (20% in the case of South Africa).
- **China and other countries:** Exempt from tax any transaction involving the shares of a publically traded company.
- **China and other countries with treaty exemptions:** Enter into treaties that exempt from tax the disposition of interests in entities in the residence country holding assets in the source country.

Pros and cons of the alternatives: Some minimum disposition requirement is needed in order to make an indirect tax administrable. The exact nature of a minimum stakeholder requirement is a choice for each country to make. Countries should carefully consider whether they wish to forego taxing Indirect Transfers of mineral rights before they concede this point in any tax convention into which they enter. See Section E for a further

³¹ An example of this is the case of Riversdale Limited set out above. The value of the transaction derived largely due to Riversdale Limited's ownership of the Mozambican company (and therefore its coal rights).

discussion of treaties.

4.5 Other Transactions and Internal Reorganizations

The internal reorganization of a company can involve an Indirect Transfer of Indirect Interests, leading to a significant gain for the group of companies. This situation is illustrated by a case involving Cairn Energy.

Cairn PLC is an Edinburgh based exploration and development company, operating mostly in India, Bangladesh and Nepal. Cairn UK, a company incorporated in the UK, is a wholly owned subsidiary of Cairn PLC. CIHL, a company incorporated under the laws of Jersey was a wholly owned subsidiary of Cairn UK. CIHL has direct and indirect holdings in 27 subsidiaries incorporated in multiple jurisdictions; 14 had operations in India.

In 2006, Cairn went through an "internal restructuring". Thereafter, Cairn India was incorporated under the laws of India as a wholly owned subsidiary of Cairn UK. A Share Purchase Agreement was executed between Cairn PLC, Cairn UK, CIHL and Cairn India in October 2006 whereby Cairn UK transferred its entire shareholding in CIHL to Cairn India for cash and Cairn India shares.

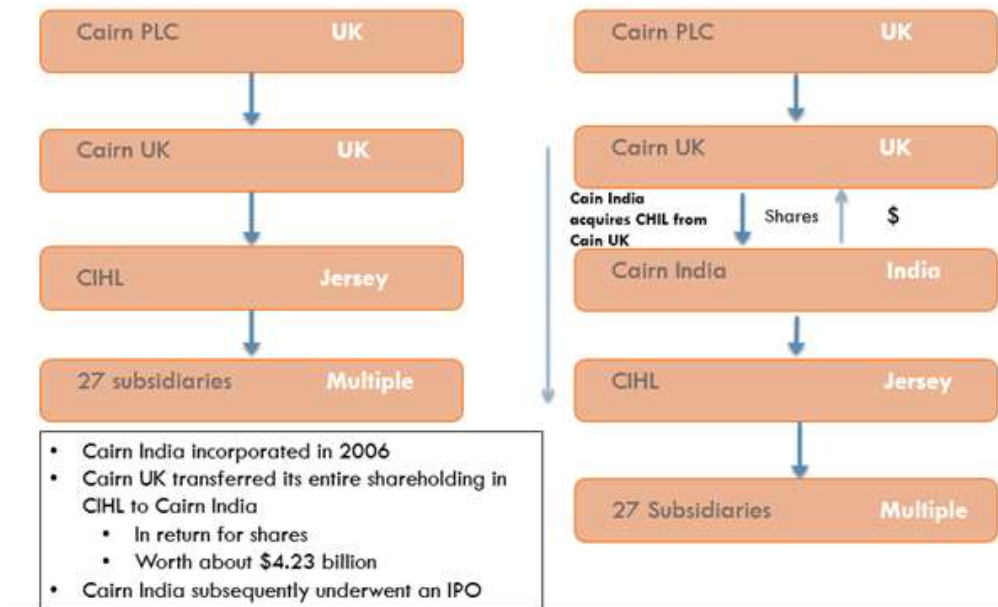
Post transfer, Cairn India owned (through CIHL) all of the Indian subsidiaries. Cairn India then raised \$1.98 billion by listing its stock on the Indian stock market in 2007. Out of this sum, about \$1.24 billion was distributed to Cairn UK and Cairn PLC with the balance being retained by Cairn India. On its financial statement for 2007, Cairn PLC reported an exceptional gain of \$1.537 billion on the deemed disposal of a 31% interest in Cairn India.³²

The Indian government sought to impose a transfer tax on Cairn UK for the entirety of its transfer of its shares in CIHL to Cairn India under a retroactive enactment of a provision to its tax law. As the amendments to the Income Tax Act were retrospective and India imposed the tax a number of years after the event, Cairn UK took India to court in India and to arbitration under the UK-India Bilateral Investment Treaty. A number of issues between the various parties to the transaction are still being litigated.³³

³² Cairn's financial statement for 2007 covering the transaction is available at: <https://www.cairnenergy.com/investors/results-reports-and-presentations/#Tab2017=1> (last visited 18 October, 2017).

³³ A number of issues in the Cairn case were litigated in Indian courts, including, most importantly, whether the "internal restructuring" amounted to a taxable disposition and whether the tax, which was imposed under a retroactive amendment to the tax law, was legal. On the first issue, the Indian court found that there was a taxable disposition based on the cash flows and financial statement results cited in the text. It also held for the government on the legality issue. For a discussion of the issues, see this IndusLaw article by R. Chakrabarti, P.M. Chinnappa and P. Sreenivasan, "Cairn Energy Loses Retrospective Tax Case Before Indian Appellate Tribunal", (4 April, 2017), available at: <http://www.mondaq.com/india/x/582780/tax+authorities/Cairn+Energy+Loses+Retrospective+Tax+Case+Before+Indian+Appellate+Tribunal> (last visited 18 October, 2017).

Figure 3 – Cairn Energy³⁴



As can be seen by the example of Cairn Energy, the Indian assets were indirectly transferred by the sale of the offshore holding company from the UK entity to a newly formed Indian company, in return for a substantial payment flowing out of the proceeds of the initial public offering. In substance, Cairn PLC reduced its stake in Cairn India by 31% and in return received over \$1.2 billion from Cairn India's public offering. While India's attempt to tax the gain on the entire transfer of CHIL's shares to Cairn India seems overly assertive, it is arguable that the combination of the IPO with a substantial distribution of the proceeds resulting therefrom should have resulted in a taxable deemed disposition equal to the dilution of the parent company's ownership in its subsidiary.

In short, taxpayers may try to avoid a tax on a sale of shares by having the target company issue new shares to new investors. This can constitute an effective transfer of the value of the company from existing to new shareholders when it is done in the fashion similar to the transaction executed by Cairn Energy. This is not to say that every internal restructuring results in a gain to a holding company that should be subject to tax by a source country. Some care must be exercised to ensure that the transaction subject to tax is actually one in which a gain is realized. In such a situation where an "internal reorganization" leads to an Indirect Transfer of an Indirect Interest to a third party, the transaction should be subject to the capital gains tax.

Suggestions as to treatment of other transactions – Source countries cannot anticipate all

³⁴ Author's own diagram.

of the forms by which an investor holding a substantial interest in an entity located in its country will dispose of its interest. For this reason, some form of a SAAR (focused on Indirect Transfers occurring in the context of a reorganization) or a GAAR may be helpful in dealing with complex and unusual disposition transactions.

4.6 The Specific Issue of Step-Up of Basis in Assets³⁵

The tax administration needs to decide if it wants to:

- a) impose a tax on gain on the seller and allow a corresponding step-up on the source country company's assets to the buyer;
- b) impose a tax on gain on the seller but restrict deductions for the buyer by not allowing a step-up; or
- c) reduce the level of tax on gain on the seller to ameliorate the impact of the "double" tax and not allow a step-up.

A simple example will illustrate the issue. Assume Investor A contributed 100 to Company X and received in turn all of Company X's stock. After operating the company for several years, Company X has assets on its balance sheet of 150 and a net worth of 150. The value of the company, however, is 200. At this point, Investor A sells its stock to Investor B for 200. Investor A has realized a gain of 100 (200 minus its tax basis in its stock of 100) and is taxed on this gain. Should the basis in Company X's assets be stepped-up (i.e.: increased) to 200 (from 150) to reflect the amount paid by Investor B for Company X's stock? In other words, can Investor B, the buyer, step-up the pre-acquisition tax basis of Company X 's assets to their fair market value (revealed by the acquisition)? A step-up in the basis of the assets will give rise to future depreciation and other deductions by Company X on the increased value of its assets.

An argument can be made that a step-up in the above example should be allowed as a matter of fairness and to avoid a double tax on the 50 of appreciation (since the appreciation has already been taxed by the capital gains tax imposed on Investor A). However, the legal provisions for doing this can become quite complicated, and the administration of a step-up in basis provision can be difficult. For example, the appreciation in value reflected on the indirect sale of the interest in the source country company will need to be allocated over the assets of this company and may result in an attribution to goodwill.³⁶ Some countries do not permit a tax deduction in respect of goodwill.

³⁵ This discussion supplements the discussion in Section A of the paper concerning the Platform's two alternative models for taxing Indirect Transfers. In a deemed disposal of assets, a step-up in the basis of the assets in the source country will flow naturally from the nature of the deemed transaction. This is not the case involving the taxation of a transfer of an interest in the company holding the assets.

³⁶ Goodwill: "Goodwill is an intangible asset that arises as a result of the acquisition of one company by another for a premium value. The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represents goodwill. Goodwill is considered an intangible asset because it is not a physical asset like buildings or equipment. The goodwill account can be found in the assets portion of

A further complication can result if only a percentage of the interest in the source country company is disposed in an Indirect Transfer. In this situation, should a step-up be made for the percentage of stock sold on each source company asset or should the step-up be confined to select assets? This too will present a considerable practical problem. Finally, a step-up should only be adopted for Indirect Transfers if a jurisdiction also provides for it in purely domestic transactions. For these reasons and the reasons discussed below, some countries may choose not to permit step-ups. The disallowance of a step-up, if clear from the tax law, will be understood by investors and be reflected in a lower purchase price paid for the interest being acquired.

Angola's 2005 oil tax legislation for direct transfers provides an example of how the step-up can work. The buyer of a license interest gets a deduction of the same amount as is taxed on the seller (meaning that the buyer is authorized to benefit from a step-up tax basis which is then depreciated). The difference is that the seller's gain is taxed immediately while the buyer's deduction is allowed by way of depreciation allowances spread over a number of years following the sale. Therefore, the government still gains by bringing forward the cash flow and winning on a net present value basis.

The second case is when the buyer does not get any deductions or gets very restricted deductions. This is the law in the US and in several other countries. The argument in favour of imposing the two levels of tax is that it preserves the system of taxing corporate profits separately from the tax imposed on investors holding shares. Put in words for this paper, it preserves the distinction between the resident country taxpayer and the source country company. Moreover, in many cases, the residence country will impose no capital gains tax either because its law does not provide for such a tax, or the tax is eliminated by a treaty provision. In these cases, if the source country does not impose a tax on the Indirect Transfer, no tax at all will be imposed on it, and no step-up should be required. Thus, while companies may dislike this asymmetric treatment, a good argument can be made in favour of it.³⁷ Furthermore, this position will enhance the overall tax revenue to the source country. For example, Liberia decided not to include a step-up provision in its Indirect Transfer tax law (see Box 9).

The third alternative is simply to reduce the level of tax on Indirect Transfers, thus reducing the effect of the two levels of tax, while also denying the buyer any step-up in basis of the source country company's assets. This lessens the overall amount of the two taxes, ameliorating the effect of them, but leaves in place the distinction between the resident country taxpayer and the source country company.

a company's balance sheet." Investopedia, definition of goodwill, found at: <http://www.investopedia.com/terms/g/goodwill.asp> (last visited 18 October, 2017).

³⁷ In the US, the tax law was changed to eliminate most step-ups with the acceptance of the argument that the two levels of tax were needed to preserve the essential distinction between a corporate income tax and a shareholder capital gains tax. See the discussion in Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, pp. 328, et seq. (1987).

Box 9: Liberia: No Step-Up in Basis

(b) *Transfer of Interest.* If the holder of an interest in a petroleum project transfers that interest—

(1) The taxable income of the project shall continue to be determined using the tax cost and other tax attributes applicable at the date of the interest transfer. **(Liberia Revenue Code as amended in 2011 and 2016, Section 750)**³⁸

Summary of alternatives – A country may elect to allow a step-up, disallow one or adopt a middle ground where it disallows a step-up but reduces its rate of tax on the transfer of interests in the source country company. Good arguments can be made in favour of each of the alternatives. However, a provision in source country law that permits a step-up will be difficult for most source countries to administer. For this reason and the other reasons expressed above, we believe a step-up provision should not be adopted by most developing countries.

5. DESIGNING A LAW WITH IMPLEMENTATION AND ENFORCEMENT IN MIND

Enforcing a capital gains tax on Indirect Transfers is fraught with challenges: first, such transactions are hard to detect because they occur offshore and, second, even if detected, it is hard to penalize a non-resident seller for defaulting on a tax payment due to the source country. There are however solutions and legal mechanisms at the disposition of the source country.

5.1 Notification to the Source Country of the Transfer.

The solutions that have been implemented mainly require self-reporting by the transferor (as in China, Australia, Japan and Canada) and reporting by the transferee (as in India and Canada). The latter is more effective than the former given the transferee's presence in the country and/or continuing interest in source country assets, and the fact that the transferee is not the party paying the tax.

The question is then when to impose this notification/reporting requirement. To optimize the ability of the government to collect a tax, the investor should be required to inform the government before the transaction occurs, as in Canada (see Box 11). Some

³⁸ The Liberia Revenue Code as amended in 2011 is available here: <http://www.ifrc.org/Global/Publications/IDRL/DM%20acts/The%20Revenue%20Code%20of%20Liberia%20As%20Amended%202011.pdf>. (last visited 18 October, 2017). A similar provision appears in Section 712(b) of the Liberia Revenue Code applicable to mining projects.

governments, only require reporting after the transaction has occurred which may limit their ability to collect the tax. The government can impose a penalty (as is done in Chile) or enforce this right by putting a lien on the local assets in case of non-notification.

Chile requires reporting of a transaction after it has taken place.

Box 10: Chile: Reporting Requirement

On July 30, 2015, the Chilean IRS issued Resolution No. 65 including Form 1921 that sets forth the reporting requirements for Indirect Transfers:

- "a) The identification of the declarant and his representative in Chile, when applicable;
- b) Identification of the alienator and his representative in Chile;
- c) Identification of the acquirer or assignee and their relationship with the counterparty;
- d) The identification and other records of the legal entity constituted or resident abroad or of the entity or assets, constituted, formed or resident abroad, the corresponding corporate rights, shares, quotas, bonds or other convertible into actions or corporate rights; or the entity of any type or assets, constituted, formed or resident abroad associated with other rights representing the capital or titles or property rights, that respectively alienate and acquire, the persons identified in letters b) and c) above *[Section d seeks the identification of the foreign buyers and / or sellers who are involved in the Indirect Transfer]*.
- e) The description of the corporate rights, shares, quotas or other rights representing the capital alienated or the titles or property rights alienated and the conditions in which the operation is carried out *[Section e asks for the description of the interest in the source company being sold and of the Indirect Transfer transaction]*;
- f) The description of the bonds or other securities convertible into shares or corporate rights alienated, and of the company or entity issuing such shares or corporate rights that would be received in the conversion, when applicable;
- g) The description of the shares or corporate rights that would be received in the conversion of the bonds or other titles, when applicable;
- h) The price and form of payment of the operation;
- i) The description of the underlying assets located in Chile;
- j) The determination of the income or greater value in the operation and the applicable tax regime; and

k) The signature of the taxpayer or his representative in Chile, as appropriate." (**Resolution 65, Article 1 – As translated literally by the authors with the bracketed phrases provided to clarify the translated language.**)

The delay or omission in the presentation of the form can result in a penalty that ranges from 20% to 100% of an annual tax unit that is approximately US\$ 700 as of August 2015. "Additional penalties could be applied to the transferor and the buyer if the Chilean tax authorities determine that a Chilean tax was due but not timely paid."³⁹

Canada requires reporting by the seller prior to the transaction and by the buyer after it is consummated.

Box 11: Canada: Reporting Requirements Imposed on Both the Seller and the Purchaser:

- Before the transaction, the non-resident seller should report on (Section 116 (1)):
 - "(a) the name and address of the person to whom he proposes to dispose of the property (in this section referred to as the "proposed purchaser");
 - (b) a description of the property sufficient to identify it;
 - (c) the estimated amount of the proceeds of disposition to be received by the non-resident person for the property; and
 - (d) the amount of the adjusted cost base to the non-resident person of the property at the time of the sending of the notice."
- After the transaction - not later than 10 days after the disposition, he should report on (Section 116 (3)):
 - "(a) the name and address of the person to whom the non-resident person disposed of the property (in this section referred to as the "purchaser"),
 - (b) a description of the property sufficient to identify it, and
 - (c) a statement of the proceeds of disposition of the property and the amount of its adjusted cost base to the non-resident person immediately before the disposition, unless the non-resident person has, at any time before the disposition, sent to the Minister a notice under subsection 116(1) in respect of any proposed disposition of that property and
 - (d) the purchaser was the proposed purchaser referred to in that notice,
 - (e) the estimated amount set out in that notice in accordance with paragraph 116(1)(c) is equal to or greater than the proceeds of disposition of the property, and
 - (f) the amount set out in that notice in accordance with paragraph 116(1)(d) does not exceed the adjusted cost base to the non-resident person of the property immediately before the disposition."

³⁹ Quote taken from a PwC write-up on the law, "Complying with Chilean Reporting Rules for Indirect Transfers", (13 August, 2015) available at: <https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-complying-with-chilean-reporting-rules-indirect-transfers.pdf> (last visited 18 October, 2017).

"116 (5.02) Notice by purchaser in respect of an acquisition of property

A person (referred to in this subsection as the "purchaser") who acquires property from a non-resident person provides notice under this subsection in respect of the acquisition if the purchaser sends to the Minister, on or before the day that is 30 days after the date of the acquisition, a notice setting out

- (a) the date of the acquisition;
- (b) the name and address of the non-resident person;
- (c) a description of the property sufficient to identify it;
- (d) the amount paid or payable, as the case may be, by the purchaser for the property; and
- (e) the name of the country with which Canada has concluded a tax treaty under which the property is a treaty-protected property (...)" **(Income Tax Act, Section 116)**⁴⁰

Summary of alternatives

- **Canada reporting of transaction:** The seller must report the transaction prior to its consummation; the buyer must report on it after it is consummated.
- **Chile:** After the transaction, the seller must report on the transaction, and the buyer and the local entity must supplement the report with any details that are missing in the seller's report.

Pros and cons of the alternatives: The Canadian alternative provides the government with a better chance to monitor the transaction and insure that any tax is collected. However, the pre-transaction reporting requirement may be hard to enforce. Irrespective of the timing for reporting a transaction, governments should require that they be provided with copies of the all pertinent documents duly certified as to their authenticity by senior officers of the companies involved in an Indirect Transfer.

5.2 Possible Enforcement Actions

A number of different enforcement measures are possible.

To begin with, there could be a clear legal stipulation that if the transfer is not reported, the transfer will not be approved. Alternatively, the stipulation could provide that if the transfer is not reported *and* the relevant tax is not paid, the rights to the assets can be revoked, as is done in Guinea.

Box 12: Guinea - Enforcement

"(...), this capital gain is taxed at source in Guinea as corporate tax and at the legal rate set forth in Article 229 of the General Tax Code. The tax is deducted at source by the

⁴⁰ Government of Canada, Justice Laws Website, Income Tax Act, available at: <http://laws-lois.justice.gc.ca/eng/acts/I-3.3/page-106.html?txthl=116#s-116> (last visited 18 October, 2017).

legal entity holding the mining permit or Authorization. This deduction at the source is payable when the capital gain is realized.

The non-payment of the deduction at source when due is penalized by the revocation of the Mining Permit or Authorization in accordance with the provisions of this Code."⁴¹
(Guinea Mining Code as amended in 2013, Art. 91 IV)

Another incentive to compliance can come from a rule that says that, if the tax is not collected in any transaction, the transferee in that transaction will have the basis of the most recent transaction for which tax was collected. This would mean that if tax is not paid, then when the transferee sells, it will be taxed on gains that were realized by previous owners. The provision prevents a step-up in basis on the Indirect Interest, a more drastic remedy than simply not providing for a step-up in basis of the underlying assets inside the company in question.

Transferee reporting is in turn rarely imposed without transferee withholding meaning that the tax is collected through withholding by the buyer from the purchase price. This technique makes both the seller and the buyer liable for the tax. Both Canada and India require the transferee to withhold from gross proceeds paid to the transferor, irrespective of whether the transferee is domestic or foreign. A number of countries in addition make the amount required to be withheld a personal tax liability of the transferee in case of default.

Box 13: Canada - Liability of purchaser

(5) Where in a taxation year a purchaser has acquired from a non-resident person any taxable Canadian property (other than depreciable property or excluded property) of the non-resident person, the purchaser, unless:

- a) after reasonable inquiry, the purchaser had no reason to believe that the non-resident person was not resident in Canada, (...) or
- b) a certificate under subsection 116(4) has been issued to the purchaser by the Minister in respect of the property, is liable to pay, and shall remit to the Receiver General within 30 days after the end of the month in which the purchaser acquired the property, as tax under this Part for the year on behalf of the non-resident person, 25% of the amount, if any, by which
- c) the cost to the purchaser of the property so acquired exceeds
- d) the certificate limit fixed by the certificate, if any, issued under subsection 116(2) in respect of the disposition of the property by the non-resident person to the purchaser,

⁴¹ See footnote 28.

and is entitled to deduct or withhold from any amount paid or credited by the purchaser to the non-resident person or otherwise recover from the non-resident person any amount paid by the purchaser as such a tax. **(Income Tax Act, Section 116)**

If the transferee is a non-resident, enforcing withholding is not a quick enforcement win. For this reason, countries have imposed a tax lien on the local assets. For instance, in India, the obligation is on the Indian target company to report all changes in ownership upstream; the withholding obligation is on the buyer, without any exception even in the case of share market transactions. India can also take action against other assets of the seller that are based in India. In the case of Cairn Energy, the Indian Government has restricted Cairn PLC from selling its shareholding in Cairn India until the capital gains tax amount is paid.

Here care should be taken to avoid infringing on the rule of law: if the transferee, including a remote transferee, is not legally made liable for the tax that the transferor fails to pay, the administration cannot seize the asset located in the country and expropriate its value from the new owner of the assets.

Even if this liability exists, the rationale to demand tax payment from the domestic company itself when the tax is imposed on the capital gains realized on the alienation of a domestic company's shares is debatable: it can indeed produce inequitable results when the company has an additional shareholder that is not selling its shares of the company. In addition, a tax lien can hinder financing. When the transferee is made legally liable for a capital gains tax on an Indirect Transfer as clearly defined in the source country law, it is fair to assume that the tax lien will be deemed legitimate by the transferee. In other circumstances, governments should consult with international tax attorneys to avoid being taken to arbitration or to the courts.

In addition, withholding does not go without additional compliance burdens: withholding on capital gains is generally not accurate and often triggers an application for refund or an examination by a tax authority.⁴² Some withholding taxes are designed to be final (albeit subject to a refund action) and others are designed to be preliminary and subject to an administrative review to determine the final amount due.

As an example, Liberia gives taxpayers who have suffered a withholding tax an option to file a tax return with the correct amount of tax due and take a credit against the reported liability for the tax withheld.

⁴² See the discussion of this issue in Cui at Section VI, A.

Box 14: Liberia: Taxpayer can elect to file a tax return to determine proper tax liability on transaction where tax was withheld

“(i) **Election.** A non-resident subject to tax under this section may elect to file an income tax return by submitting it at the time and in the manner required by Part I and Chapter 9 of this Code, and is thereby required to pay the amount of income tax on taxable income specified in Section 200 or Section 201. An amount of tax withheld pursuant to Section 806 is creditable against income tax liability and refund of an overpayment may be available as described in Section 72. (...)” **(Liberia Revenue Code as amended in 2011 and 2016, Section 806(i))**

Given all these challenges associated with tax collection and enforcement, it is recommended that governments should invest in creating a small team within the tax administration that will be responsible for dealing with these transactions each time they occur, accumulating experience over time.

Summary of alternatives

- **Canada and India:** Impose a withholding tax on the buyer on the payment due on the sale of the Indirect Interest in the source country enterprise.
- **Other countries:** Countries may employ a variety of other methods to compel payment of tax on the capital gains realized on the sale of an indirect interest in a source country enterprise, including putting a lien on in-country assets, creating a liability for the tax on the holder of the mineral interest in-country, and denying a step-up in the basis of the interest acquired or on the underlying assets held in the source country.

Pros and cons of the alternatives: Source countries should have available a variety of means to collect the tax due on an Indirect Transfer. The most effective method may be to impose a withholding tax on the payment being made by the buyer. Some care must be exercised in imposing the tax on the holder of the local mineral rights in order to avoid unfairly penalizing owners of interests in the mineral rights not involved in the indirect sale.

6. HOW DO INTERNATIONAL TREATIES COME INTO PLAY?

Countries seeking to design laws to apply a tax to Indirect Transfers need to examine their bilateral tax treaties to make sure that they do not forbid such a tax.

According to the IMF, there has been a rapid increase in the number of bilateral tax treaties entered into over the 20 years to 2013, largely driven by developing countries

entering into these treaties.⁴³ While such treaties can solidify a source country's taxing rights and make them clearer, many of those in existence do not have strong provisions to permit capital gains tax on Indirect Transfers, or they define source rights too narrowly so as not to capture all types of assets. Many prevent the imposition of capital gains tax at all. In any of these cases, the country is limited in its ability to enforce provisions capturing Indirect Transfers of assets in its domestic legislation.

Therefore, countries entering into bilateral tax treaties should carefully consider these issues. If the treaty is to provide for taxation of Indirect Transfer of assets, it must first stipulate that the country in which assets are located retains the taxing rights for those transactions.⁴⁴ Typically, it will state that income of a non-resident derived from immovable property in a source country may be taxed in that country, for example:

"Gains derived by a resident of a Contracting State from the alienation of immovable property...situated in the other Contracting State may also be taxed in that other State." (OECD Model Convention, Article 13.1)

From the above, we understand that the definition given to "immovable property" in the bilateral tax treaty is important, as it should be broad enough to capture transfers of mineral and petroleum rights.

Many bilateral tax treaties follow language used in the OECD and UN Model Conventions. While both of these models provide for the taxation of gains arising from an Indirect Transfer, it is important to note the limits in both of these model conventions. The UN Model Convention is discussed below by way of example.

Box 15: The UN Model Convention

The definition of "immovable property" is quite wide in the UN Model Convention; however, it does not specifically include all forms of interests in extractive industry assets.

"Immovable property" is widely defined (Article 6(2)):

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and **rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources**; ships, boats and aircraft shall

⁴³ IMF, "Spillovers in International Corporate Taxation", (2014), pp. 25-28 (hereinafter, IMF Paper), available at: <https://www.imf.org/external/np/pp/eng/2014/050914.pdf> (last visited 18 October, 2017).

⁴⁴ IMF Paper, p. 71.

not be regarded as immovable property (emphasis supplied).

The UN Model Convention then provides taxing rights to the source country for direct or Indirect Transfer of immovable property located in that source country.

(13)(4). Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.

For the purpose of Article 13(4), "principally" is defined as:

"the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate".

The OECD Model Convention has language in its Article 13.4⁴⁵ dealing with the types of interests giving rise to a capital gains tax that is somewhat different from that quoted from the UN Model Convention and arguably more restrictive in nature. However, the 2017 update of the OECD model convention reads much the same as the UN convention:

Box 16: OECD: Update on OECD Model Convention

Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 % of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.
(OECD Model Convention, Proposed Article 13.4)

Countries should be careful of a provision in a bilateral tax treaty which provides that all income that is not specifically dealt with in the treaty may be taxed only in the state in

⁴⁵ The Platform Paper notes "that the likelihood that Article 13.4 is included in a treaty is significantly:

Lower, if one of the treaty partners is a resource-rich low-income country,

Lower if one of the treaty partners is a low tax jurisdiction,

Higher, the greater is the difference between the rates at which capital gains are taxed in the treaty partners and increasing over time."

For countries lacking article 13.4 in their treaties, Article 9(4) of the MLI effectively incorporates such a provision into their tax treaties provided both treaty countries agree to this under the MLI process. See the Platform Paper, "The Taxation of Offshore Indirect Transfers – A Toolkit", (2014), available at: <https://www.oecd.org/tax/discussion-draft-toolkit-taxation-of-offshore-indirect-transfers.pdf> (last visited 18 October, 2017).

which it arises (also based on the language in the UN Model Convention). For example:

"Items of income not dealt with in the foregoing Articles of this Agreement shall be taxable only in the Contracting State in which they arise."

If the definition of "immovable property" is not wide enough to capture a sale of shares or a transfer of a mineral right, then there may be an argument that in the case of a sale of shares of an offshore holding company, the income arises in that offshore country. Similarly, where sale of a mineral or petroleum right is concluded between two countries offshore, the income may be argued to arise offshore. This would limit the source country's ability to tax that income in countries with which it has such bilateral tax treaties.

As can be seen from the full history of the Cairn Energy case, in addition to bilateral tax treaties, bilateral investment treaties can also limit countries seeking to impose this tax. Companies can use bilateral investment treaties to bring arbitral proceedings, alleging that imposition of the tax is an expropriation of property without compensation or a denial of fair and equitable treatment under the source country's laws. Countries should leave tax provisions out of bilateral investment treaties and include them, if necessary, only in bilateral tax treaties.

Suggestions on tax treaty alternatives – Source countries may choose to follow the UN or OECD Model Conventions or some modification of them (thanks to the MLI in particular) or choose to pursue no tax treaties. If a country wishes to enter into a tax treaty that includes customary language relating to source country taxation of transfers of immovable property, it should ensure that mineral and petroleum interests and all activities relating to the realization of the value of these interests are within the definition of the treaty term "immovable property".

In addition, countries should insert an article in their tax treaties to guard against treaty shopping by investors seeking to inappropriately use a treaty from a jurisdiction in which they have only a nominal presence but that has favourable provisions that will reduce their source country taxes. Treaty abuse articles can take one of two forms or a combination of the two. The first is a limitation on benefits (LOB) provision. This type of provision focuses on the legal nature, ownership in, and general activities of the investor in the treaty jurisdiction. It seeks to ensure that there is a sufficient link between the investor and the treaty jurisdiction to warrant the treaty's use by the investor. LOB articles can be long and complex and may be difficult for developing countries to employ effectively.⁴⁶ The second is a principal purpose test (PPT). The PPT takes the form of a SAAR to prevent treaty shopping. The OECD suggests the following language for a PPT:

⁴⁶ For example, in the U.S. Model Tax Convention, the LOB provision is contained in Article 22. It is about nine pages in length.

Box 17: OECD Suggestion: Model PPT Provisions

(...) [A] benefit under this convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.⁴⁷

Even though a PPT is subjective in nature, most developing countries would be wise to include this form of provision guarding against treaty abuse in their tax treaties.

Countries may choose not to enter into any tax treaties. This will give them the flexibility to apply source country law without worrying about treaty overrides. This alternative should be considered when a country decides that it will not discourage in-bound investments by refusing to enter into tax treaties.

7. CONCESSION AGREEMENTS OTHER CONTRACTUAL ARRANGEMENTS

Previously, we mentioned the importance of concession agreements or other contractual arrangements with regards to the taxation of Indirect Transfers. Most developing country governments own the rights to the mineral and petroleum interests located in their country. Hence, the rights to develop such interests are granted to third parties by the host country government through some form of a contractual arrangement. In the few cases where the rights to mineral interests are privately held, the local government may not be involved in the contract relating to the development of these interests. That said, they may still be asked to make certain tax concessions in connection with the development of the mineral interests.

To this point, the paper has presented issues and options for developing countries to consider in enacting laws to tax Indirect Transfers. However, the best set of laws on such transfers can be rendered superfluous if the right to tax Indirect Transfers is given away in a concession agreement or other contractual arrangement. More importantly, a concession agreement or contractual arrangement should contain requirements directed at assuring collection of tax on an Indirect Transfer.

⁴⁷ OECD Action 6 - Final Report, "Preventing the granting of treaty benefits in inappropriate circumstances", (2015), p.55, available at <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm> (last visited 18 October, 2017). See also MLI, Article 7(1). (A PPT similar to the quoted language is incorporated into treaties ratified by signatory jurisdictions to the MLI.)

Often government officials negotiating contracts for rights to mineral or petroleum interests will be asked to give up taxing rights as part of an incentive program to encourage the investment to be made. There is some value to incentive programs. However, in many instances their value can be overstated. The IMF conducted a study on the use of tax incentives by developing countries. They concluded that they frequently do not need to be employed to obtain the desired investment.⁴⁸

For the foregoing reasons, we recommend that concession agreements and other contractual arrangements should not supersede a well-drafted law that stipulates the taxation of Indirect Transfers. As noted, a better use of such agreements would be to complement the law and regulations when those are not sufficiently well drafted to enforce the imposition of capital gains tax on Indirect Transfers.

8. CONCLUSION

This paper has aimed at providing practical guidance for countries that may decide to introduce a tax on Indirect Transfers of extractive industry assets that are located in their jurisdiction. It builds on the momentum created by the recently released Platform Paper on the taxation of Indirect Transfers. The Platform Paper's tax recommendations are based on the provisions in the UN Model Convention and the draft changes to the OECD Model Convention that provide for the taxation of such transfers of "immovable property" including within that term all forms of mineral interests.

By contrast with the Platform Paper, this paper brings particular attention to the complex issues of implementation and enforcement and aims at informing the legal authorities and tax administration's work by providing actual language from other jurisdictions that have already enacted tax laws taxing these transfers.

We hope that the suggestions made here will assist developing countries to enact sound laws on the taxation of Indirect Transfers of extractive industry assets.

⁴⁸ IMF, OECD, UN, and World Bank, Report to the G-20 Development Working Group, "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment", (2015), pp. 11-15, available at: <http://documents.worldbank.org/curated/en/794641468000901692/pdf/100756-Tax-incentives-Main-report-options-PUBLIC.pdf> (last visited 18 October, 2017).

ACRONYMS, ABBREVIATIONS, AND GLOSSARY

BEPS: The Base Erosion Profit Shifting (BEPS) project is an OECD-led initiative designed to rein in tax avoidance strategies that exploit gaps and mismatches in tax rules.

GAAR: A General Anti-Avoidance Rule (GAAR) is a rule enacted in the tax law to give the government broad authority to disallow positions taken by taxpayers on tax returns that violate the spirit of the tax law.

Global Forum: The Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) is the multilateral framework within which work on transparency and exchange of information for tax purposes has been carried out by both OECD and non-OECD economies since 2000.

Indirect Interest: An Indirect Interest is an ownership interest in an asset in which there is at least one intervening entity in the chain of ownership between the asset in question and the owner in question.

Indirect Transfer: An Indirect Transfer is the disposition of an indirect ownership interest in an asset, in whole or in part.

MLI: The Multilateral Instrument (MLI) is the multilateral convention drafted by the OECD to implement treaty-related measures to prevent BEPS transactions by taxpayers. To date, over 70 countries have entered into or agreed to enter into the MLI.

OECD Model Convention: Model Tax Convention on Income and Capital of the OECD.

Platform: The Platform for Collaboration on Tax (Platform) is a joint initiative of the IMF, OECD, UN and World Bank Group.

Platform Paper: The Platform Paper is a discussion draft produced by the Platform on issues relating to the taxation of Indirect Transfers of mineral interests in developing countries entitled: "The Taxation of Offshore Indirect Transfers – A Toolkit".

SAAR: A Specific Anti-Avoidance Rule (SAAR) is a rule enacted in the tax law to give the government authority to disallow particular types of positions taken by taxpayers on tax returns that violate the spirit of the tax law.

UN Handbook: United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries.

UN Model Convention: Model Tax Convention on Income and Capital of the UN.

REFERENCES AND USEFUL RESOURCES

BEPS: Information on the BEPS project is available at: <http://www.oecd.org/tax/beps/>.

L. Burns, H. Le Leuch, and E.M. Sunley, "Taxing gains on transfer of interest", (2017), Chapter 7, Section 4.1; in P. Daniel, M. Keen, A. Swistak and V. Thuronyi (eds.), "International Taxation and the Extractive Industries", Routledge, London & New York.

Cui, W., "Taxing Indirect Transfers: Improving an instrument for stemming tax and legal base erosion", (2014), Virginia Tax Review, Vol 33:653.

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IMF, "Spillovers in International Corporate Taxation", (2014), available at: <https://www.imf.org/external/np/pp/eng/2014/050914.pdf>.

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MLI: Information on the MLI is available at: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>.

OECD Model Tax Convention: The OECD Model Tax Convention and the proposed changes to it are available respectively at: <http://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-2015-full-version-9789264239081-en.htm> and <http://www.oecd.org/ctp/treaties/draft-contents-2017-update-oecd-model-tax-convention.pdf>.

Platform Paper, "The Taxation of Offshore Indirect Transfers – A Toolkit", (2014), available at: <https://www.oecd.org/tax/discussion-draft-toolkit-taxation-of-offshore-indirect-transfers.pdf>.

UN Model Tax Convention: The UN Model Tax Convention is available at: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.

UN: The UN Handbook is available at: <http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf>.

ANNEX

Advantages and Disadvantages of the Platform's Model 1 and Model 2

The Platform Paper describes advantages and disadvantages of the two models described in the text in Section 2. These advantages and disadvantages are summarized below. We briefly add our own thoughts on the two models, and, while recognizing it is a debatable point, we come out in favour of Model 2.

Our paper is a practical guide on how to enact laws to implement the taxation of Indirect Transfers. It is not designed to go into the details of the two models. We simply provide a general overview of them.

Platform's Discussion Points (as taken directly from the Platform's paper on Indirect Transfers):

Model 1 – Deemed disposal model

Advantages:

1. Source countries will have a greater ability to enforce the tax under this model.
2. The step-up in the tax basis of the assets of the source country assets will avoid a double tax on the Indirect Transfer.
3. Most treaties that would otherwise prohibit the imposition of a tax on an Indirect Transfer will not come into play.

Disadvantages:

1. Treaty provisions may still prohibit the imposition of a tax on an Indirect Transfer.
2. A double tax may be imposed on the seller of the interest because its country of residence may impose a tax on the transfer and not permit a foreign tax credit for the taxes arising on the deemed sale of assets.
3. Because the source country company is not involved in the sale and does not have access to the proceeds of the sale, it may not have sufficient funds to pay the tax.
4. The deemed disposal undermines the legal entity distinction between the resident country taxpayer and the source country company.
5. The model requires the source country entity to monitor changes in its ownership structure in order for the tax to be imposed.

Model 2 – Tax non-resident seller

Advantages:

1. The model preserves the legal entity distinction between the resident country taxpayer and the source country company.
2. Investors are less likely to suffer two levels of tax because the residence country of the investor will likely permit a credit against any tax it imposes for the tax imposed by the source country.

Disadvantages:

1. Source countries will have less ability to enforce the imposition of a tax.
2. Source countries will have greater difficulty in detecting any transfer of an indirect interest in a source country company.
3. A double tax may arise on the sale of intervening interests held between the selling enterprise's interest and the source country company in that the basis in these interests will not be stepped up for purposes of residence country tax on them.
4. Treaty provisions may prohibit the imposition of a tax on an Indirect Transfer.

Additional Thoughts

Many of the issues discussed in the text, such as what percentage of tax to impose on an Indirect Transfer of less than a 100% interest in a source company, arise under either model. Point 5 under disadvantages listed under Model 1 is largely true for both models. Hence, it does not provide a persuasive argument in favour of either model. Also, under both models, some consideration should be given on whether a tax should be imposed on a transfer made by certain types of investors (such as public shareholders and tax-exempt entities). Further, under Model 2, as is discussed in Section 2, source countries will have many effective ways of enforcing any tax. And many countries will have the ability to override adverse treaty provisions under the provisions of the MLI brought into existence by the BEPS project.

A discussion in the text of the importance of avoiding the possible imposition of two levels of tax is provided in Section 4.6 of this paper. We do not believe that this is a decisive issue for the reasons set out in that section.

In addition, a variety of thorny practical issues will arise under Model 1 in dealing with the step-up in the tax basis of the source company's assets. For example, how will the increase in basis be allocated among its assets? If allocated to goodwill, will the goodwill be amortizable and, if so, over what period? If not, two levels of tax will still be imposed. In addition, the step-up allocation problems become even more involved when only a portion of a source country company interest is the subject of an Indirect Transfer.

For the foregoing reasons, we believe Model 2 is the better model to follow for most countries.